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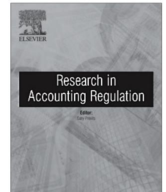

Research Report

Does disaggregation of fair value information increase the value relevance of the fair value hierarchy?

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ABSTRACT

In response to pressures from Congress, the SEC and investors, the FASB issued ASU 2010-06, *Improving Disclosures about Fair Value Measurement*. ASU 2010-06 mandates that firms provide disaggregated fair value information by class of financial instruments under each level of the fair value hierarchy. Using financial statements of publicly traded banks for the first quarters of 2009 and 2010, this study examines whether providing class-level information increases the value relevance of the fair value hierarchy. In support of our hypothesis, we find that fair value relevance increases under ASU 2010-06.

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Introduction

ASU 2010-06, *Improving Disclosures about Fair Value Measurement*, requires firms to disclose the fair values of assets and liabilities by *class*, which is defined as a subset of a line item in the statement of financial position. Prior to ASU 2010-06, fair value measurements were reported by *major category*, which most companies interpreted as a line item on the balance sheet. As a result, prior to ASU 2010-06, fair value information was mostly reported on a highly aggregated basis (e.g., as available-for-sale securities). In response to user comments that a high level of aggregation renders fair value measurements less useful, the FASB issued ASU 2010-06 requiring “finer” class level disclosures in interim and annual reports beginning after December 15, 2009.

Using financial statements from the first quarters of 2009 and 2010, we study the impact of ASU 2010-06 on the usefulness of fair value disclosures in the banking industry. We find that the level of disaggregation increases most significantly for assets fair valued under Level 2 of the fair value hierarchy.[2] For example, in 2009, banks disclosed on average (mean) 2.05 line items under Level 2 fair value assets. This number increased to 4.46 line items in 2010, an increase of more than 117%. The impact of ASU 2010-06 on Levels 1 and 3 fair value assets, however, was modest. Specifically, banks disclosed on average 0.83 (1.12) and 0.89 (1.19) line items for assets fair valued under Levels 1 and 3 in 2009 (2010).

We then examine two questions that should be of interest to policymakers. First, we study whether the increased disaggregation due to ASU 2010-06 is associated with increased fair value relevance, and second, we investigate whether this association differs across the three levels of the fair value hierarchy. The FASB contends that class-level disclosures, particularly for Levels 2 and 3 fair value

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[2] SFAS No. 157 issued by the FASB in September 2006 became effective for calendar year-end firms in the first quarter of 2008. The standard establishes a hierarchy of three levels of fair value measurements. Level 1 fair value measurements use observable prices of identical securities in actively traded markets; Level 2 measurements use observable prices of identical securities in inactive markets or prices of similar securities in active markets; while Level 3 measurements are based on unobservable inputs that are used in valuation models.

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measurements, should provide information that is useful to present and potential investors in assessing firm performance. On the other hand, the additional disclosures could result in an information overload for investors (Paredes, 2003) and decrease their usefulness.

To address our research questions, we regress the market value of equity on fair values of net assets disclosed under the fair value hierarchy, and interactions of these fair values with the number of lines reported under each level of hierarchy and the changes in the number of reported lines from 2009 to 2010. In support of our hypothesis, we find that increased disaggregation is positively and statistically significantly associated with higher value relevance for Level 2 measurements.

Research setting-background on ASU 2010-06

Subsequent to the passage of SFAS No. 157, *Fair Value Measurement*, the debate regarding the usefulness of fair value information intensified. In October 2008, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA) and asked the SEC to examine whether fair value accounting contributed to the instability in US capital markets.[3] In December 2008, the SEC released its study on fair value accounting.[4] One of the main conclusions of the study was that fair value hierarchy information is value-relevant although improvements were needed, including increased disclosures for Levels 2 and 3 measurements.

In response to the SEC's study and investor dissatisfaction with the quality of fair value disclosures,[5] in January 2010, the FASB issued *ASU 2010-06, Improving Disclosures about Fair Value Measurements*. Consistent with the SEC's recommendations, ASU 2010-06 targets for greatest improvements, fair value disclosures under Levels 2 and 3 of the hierarchy. Separately, the International Accounting Standards Board (IASB) issued similar amendments to its fair value standard (IFRS 7). Thus, ASU 2010i06 was also issued for convergence purposes.[6]

ASU 2010-06 requires that in 2010 and after, fair value hierarchy information be provided on a greater disaggregated basis, namely by *class* of financial instruments. Prior to 2010, firms were required to disclose financial instruments by *major category* which often corresponded to disclosing a line item (e.g., available-for-sale securities) in the statement of financial position. A class as defined in ASU 2010-06 would be a subset of a line item on the balance sheet. When determining the appropriate classes, management would be required to use judgment and take into account the nature and risks of the financial instruments. The fair value hierarchy would also affect this determination. Because Levels 2 and 3 measurements involve more risk and subjectivity, all else constant, these groupings were expected to have more classes of financial instruments than those in Level 1.

In the Appendix, we provide excerpts from BancorpSouth's financial statements showing how Level 2 investments displayed by major category (i.e., a single line of AFS investment) in 2009 were disaggregated into five classes under the new standard in 2010.

Prior literature and research question

Our study is related to two literature streams: (1) research on the value relevance of the fair value hierarchy and (2) research on the usefulness of information disaggregation. We contribute to these research streams by providing some of the first evidence on whether disaggregation of disclosures under fair value hierarchy provides useful information to investors.

Using both price- and return-based regressions, prior studies on fair value relevance have found that, in general, fair value information on loans, investment securities, and long-term debt is useful to investors (Barth, 1994; Barth, Beaver, & Landsman, 1996; Eccher, Ramesh, & Thiagarajan, 1996; Nelson, 1996). More recent studies have examined the value relevance of the fair value hierarchy mandated under SFAS No. 157. Song, Thomas, and Yi (2010) and Kolev (2010) find that the value relevance of Level 1 and Level 2 fair value measurements is higher than that of Level 3 measurements. Their results are consistent with investors discounting fair value measurements that are based on management's subjective estimates and/or are affected by estimation errors from the use of valuation models. Goh, Ng, and Yong (2009) find that the value relevance of Level 1 assets is the highest, but they do not find any difference in the value relevance of Level 2 and Level 3 measurements.

With regard to research on information disaggregation, prior studies have examined the usefulness of disaggregated information in: segment reporting, income statements, earnings forecasts and reported earnings. Berger and Hann (2003) find that finer segment information under SFAS 131 helps financial analysts better forecast earnings. In an experimental study, Libby and Brown (2012) provide evidence that auditors are less likely to tolerate material errors when firms prepare more disaggregated income statements, in turn leading to better reporting quality. In an experimental study, Hales, Venkataraman, and Wilks (2011) find that firms are more likely to secure financing when they separately report optional lease renewal periods and those not subject to renewal or cancellations. With regard to income statement information, Fairfield, Sweeney, and Yohn (1996) find that disaggregating net income into recurring and non-recurring items helps forecast profitability, measured by return on equity (ROE). Using archival data, Lansford, Lev, and Tucker (2011) find that analysts revise their prior estimates by a larger magnitude, and their forecasts have less dispersion when firms provide

[3] Section 133 of EESA required the SEC to conduct a study on SFAS 157 and fair value accounting in consultation with the Federal Reserve and US Treasury and submit its report within 90 days of the passage of the Act.

[4] The SEC also issued numerous comment letters requesting additional fair value disclosures in companies' filings. Hughes, Wood, and Hodgdon (2011) find that the banks' disclosures on derivatives, financial instruments and investments in securities increased significantly from 2007 to 2008 in response to SEC comment letters.

[5] The FASB received 111 comment letters in response to its Exposure Draft on improving financial statement disclosures.

[6] As a result of the convergence with IFRS 7, ASU 2010-06 should also improve global comparability of fair value disclosures on financial instruments.

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